United States Court of Appeals

for the Second Circuit

PETITIONER'S BRIEF

75-4209

C. A. No. 71-4278
(W. K.; Three-Judge Court)

USCA-2nd Nos.
75-4209 and 76-4103

United States District Court

SOUTHERN DISTRICT OF NEW YORK

Civil Action No. 71-4278 (W.K.; Three-Judge Court)

C. ORVIS SOWERWINE, Trustee in Bankruptcy of REA EXPRESS, INC., a Bankrupt, *Plaintiff*,

v.

THE ALABAMA GREAT SOUTHERN RAILROAD COMPANY, et al., *Defendants.*

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P/S

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v.

UNITED STATES OF AMERICA and INTERSTATE COMMERCE COMMISSION, *Respondents.*

BRIEF FOR PLAINTIFF AND PETITIONER, C. ORVIS SOWERWINE

+ Appendix

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BRIEF FOR PLAINTIFF AND PETITIONER, C. ORVIS SOWERWINE

ISSUES PRESENTED FOR REVIEW

1. When the owners controlling a common carrier use the carrier's sinking fund revenues to create debt to themselves without competitive bidding do they violate Section 10 of the Clayton Act?

2. Must the Interstate Commerce Commission disapprove an application under Section 20a of the Interstate Commerce Act to issue notes to a carrier's controlling stockholders, when the issuance injures the carrier and defrauds its other creditors?

STATEMENT OF THE CASE

(a) The Double Caption

The plaintiff—petitioner filed timely identical petitions to review and set aside the Interstate Commerce Commission's final order of February 11, 1976 in both of the above captioned matters. Copies of that order and the Commission's Report of July 28, 1975 are attached to each of those petitions. The purpose of the dual filing was to eliminate any jurisdictional problem that might otherwise have arisen from the 1975 amendment to the Urgent Deficiencies Act. See 28 U.S.C. 2321, Cum.Ann. 1976. This brief has been confined to a discussion of the merits of the Commission's decision and has been filed in both the Court of Appeals and the three-judge District Court.

(b) The Statutory Scheme

The controlling statutes are Section 10 of the Clayton Act, 15 U.S.C. 20, and Section 20a(2) of the Interstate Commerce Act, 49 U.S.C. 20a(2). They are reproduced in full in Appendix A of this brief and their history and purpose are discussed in our argument. As an aid to understanding the Commission's Report we shall briefly summarize them here.

Section 10 is part of a 1914 anti-trust statute, forbidding dealings between a common carrier and other corporations, having an interlocking management, where competitive bidding does not occur. It is aimed at preventing carrier injury by conflicting interests rather than an undue restriction of competition between carriers. The specified dealings are "any dealings in securities, supplies, or other articles of commerce." The Act does not define "securities". The dictionary definitions of this word include "documents evidencing a debt."

Section 20a was created by the Transportation Act of 1920 to provide a comprehensive Commission control over common carrier security issues. 20a(2) applies to all "securities" issued by a carrier and that term includes "any share of capital stock or any bond or other evidence of interest in or indebtedness of" a carrier. This section requires an investigation by the Commission of "the purposes and uses of the proposed issue and the proceeds thereof." Before approval may be given the Commission must find that it has "a lawful object", "compatible with the public interest", "is necessary or appropriate for or consistent with the proper performance by the carrier of service to the public as a common carrier", that it will not impair the carrier's "ability to perform that service" and that it "is reasonably necessary and appropriate for such purpose."

(c) The Commission's Decision

(1) The Material Facts

The Commission's Report of July 28, 1975 in Finance Docket No. 20812 summarizes the prior proceedings in that docket and in this case. It also describes the mechanics of the transactions underlying the 1959 note issue. In essence, 86 railroads acquired the working capital and capital assets needed to operate REA by investing $100,000 of their own money. A public bond issue of $32 million provided the $30 million needed to acquire REA's capital

assets from the American Railway Express Company plus more than $1 million for working capital and was retired from REA's express revenues during the period 1929-59. There was no corresponding increase in REA's net worth because as the public debt was retired it was converted into private debt to its railroad owners in the amount of the sinking fund payments to the public bondholders.

REA's Standard Express Operating Agreement provided for a direct distribution of the difference between REA's gross revenues and its expenses to its railroad owners as "rail transportation revenue" (pp. 169-170).[1] Sinking fund requirements to retire the public debt were to be deducted from the amounts paid to the railroads. But this was not done. The sinking fund payments were treated as loans from the railroads instead of as expenses and interest was regularly paid on these "loans" from REA's express revenues. As of September 25, 1959, when the Commission approved the conversion of REA's bookkeeping debt to the railroads into 14 year, non-negotiable, 5% notes, the amount of the converted debt was more than $27 million.

Although REA's sinking fund payments were not actually distributed to its stockholders and lent back to REA by them, these payments were treated as money advanced to this corporation. (p. 179). In 1954 "extensive consideration was given to the problem of repaying the advances, especially in the event of liquidation of REA or withdrawal by one or more railroads." (p. 186). The railroads concluded that in the event of liquidation the "advances," reflected on REA's books as debt to its railroad owners would be "subordinated to REA's other liabilities and were, along with capital stock, to be treated as 'capital debt' for purposes of pro rata distribution of REA's remaining assets" (p. 187). However, between 1954 and

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1 All page references in this brief are to the Commission's Report of July 28, 1975, unless otherwise stated.

1959, contrary to an opinion expressed by REA's vice-president, C. J. Jump, the railroad owners consistently treated their "advances" as ordinary debt rather than capital debt.

In 1959, its railroad owners decided to change REA into a more independently managed "profit-making entity" (p. 190). The railroads also decided to "establish formally" (p. 189) the debt by having REA issue to them non-negotiable notes payable in 14 years, carrying interest at 5%, in the amount of the debt. (p. 189). They also decided on revisions of REA's 1954 standard express operating agreement with them. (p. 190).

A hearing was held on the contract revision and one division of the Commission issued an opinion approving the new contract under 49 USC § 5(1) on September 21, 1959. Express Contract, 1959, 308 ICC 545.

In a separate docket, an uncontested 20a application for approval of the note issue was granted by another division of the Commission, without a hearing or opinion, on September 25, 1959. Railway Express Agency Inc. Notes, 307 ICC 812. "The notes were to mature on December 31, 1973, and provided that 10 percent of REA's profits under the 1959 operating agreement after January 1, 1965, would be set aside to make payment on principal" (p. 191). The Commission's approval contained pro forma recitals that the note issue was "compatible with the public interest" and would not impair REA's ability to serve the public (p. 191).

After repeated unsuccessful attempts to sell REA, its railroad owners put their stock in the hands of independent voting trustees for the purpose of selling it and terminated the 1959 operating agreement, as of the end of 1968. The independent trustees recruited a new management team in 1968, which bought the railroad's stock for about $2,000,000, plus warrants, in 1969. REA, under its

new owners, continued to pay interest on the notes, until September 1971, when this suit was filed (p. 192).

(2) The Rationale of the Commission's Approval of the Notes

After stating the contentions of the railroads, REA and the Commission's Office of General Counsel, the Commission rejected the conclusion of its Administrative Law Judge von Rinteln and its own Counsel that the notes were invalid because the underlying debt they replaced was non-existent or represented equity (pp. 202-203). The Commission then concluded, without a full evidentiary hearing, that its 1959 order was correct (pp. 205-206). The reasons for this ruling are that, "the fledgling REA had sufficient business reasons" (p. 205) for the procedure that created the debt during 1929-59; "the timing was not arranged to mislead the Commission" (p. 205); the railroads merely desired "to firmly and fairly fix rights upon liquidation" (p. 205); and the Commission had intended, when it approved the 1929 public debt, that the method of liquidating this debt then prescribed in 150 ICC 423, should not be the only permissible way to liquidate it. The Commission also reasoned that "many persons and businesses," have relied on the fact that what appeared as debt on REA's books was indeed debt, including "the present owners of REA"; therefore revocation of the 1959 order would result in "a 27 million dollar windfall" for the present owners (p. 206).

The Commission also held that the evidence of interest bearing debt to the railroad owners appearing on REA's books was not a "security", as the term is used in 20a. It could not be such a security because the Commission had consistently held that "advances" were not securities and this debt had been created by advances (p. 206-207). The Commission said however, that in authorizing a public refinancing of the public debt, pursuant to 20(a), in 1938, it had "inferentially" authorized repayment of the 1938

public debt by "advances" from the railroads' respective shares of REA's express revenues (p. 209).

(3) The Order Denying Reconsideration

On February 11, 1976 the Commission denied REA's petition for reconsideration and concluded that its 1975 Report was sound because the Commission knew, when it issued its 1929 order approving the railroad's pooling agreement under Section 5, that the public debt "might be retired in a manner other than that provided for in the pooling agreement" and that the Commission knew "at the time of its creation" that the railroads' creation of debt to themselves by "advances" made in the course of such retirement did not create a "security" within the meaning of Section 20a. The 1976 order also rejected REA claims of procedural impropriety and affirmed its 1959 and 1975 findings by restating them in the language of 20a, with the addition of a statement that "the application for the issuance of the 1959 Notes disclosed all facts insofar as they were material to such authorization." The Commission also added a conclusion that it had approved the railroads' creation of debt to themselves from the 1929-59 sinking fund payments by its 1959 approval of the notes, under 20a, and of the new operating agreement, under Section 5(1).

SUMMARY OF ARGUMENT

The Commission mistakenly treated REA as nothing more than an agent of its railroad owners. REA was in fact and law, a separate corporation with a distinct common carrier function. Its assets were not the property of its stockholders nor were they legally liable for its debts. In using REA's sinking fund payments to create fixed interest-bearing debt to themselves, REA's stockholders committed a deliberate fraud on REA's other creditors. The Commission should have condemned this fraud when asked to approve the debt's conversion into unrepayable notes

and its 1975 approval of this note issue, in the face of REA's bankruptcy, was both illegal and inequitable.

1. The Commission erred in failing to notice that Section 10 of the Clayton Act prohibited the 1929-59 creation of the debt refunded by the 1959 note issue. Section 10 is not, as the Commission mistakenly supposed, a statute merely requiring competitive bidding under certain circumstances. What Section 10 does is absolutely forbid dealings harmful to the carrier, which involve conflicts of interest. Competitive bidding is only a means of preventing the damage to a carrier that is presumed to result from conflicting interests, when arms length negotiations are not possible. It was the conflict of interest between the aims of REA and its railroad owners, exemplified in self-dealing by their interlocking directors, that made illegal the railroads' 1929-1959 practice of using the retirement of REA's public debt to create new interest-bearing debt to themselves.

Under any conceivable definition of dealing in a carrier's securities, conversion of an REA public bond issue into private interest-bearing debt to REA's railroad owners and managers falls within Section 10. That accounting conversion violated the statute because the competitive bidding safeguard against self-dealing was not available.

The Commission does not enforce the criminal liability created by Section 10, but the Commission is bound not to sanction what Section 10 prohibits when it investigates an issuance of carrier securities under 20a. The Supreme Court described Section 10's purpose in 1959 as preventing "financial injury of the carrier and the consequent impairment of its ability to serve the public." *Minneapolis & St. Louis Railway Company* v. *United States,* 361 U.S. 173, 190. In footnote 13, p. 190, it restricted coverage of Section 10 to "a carrier's dealings with related persons in its own securities", but that is precisely the coverage involved here.

The Second Circuit of Appeals unanimously construed Section 10 the same way in *Klinger* v. *B. & O. Railroad Co.*, 432 F.2d 506 (1970). The railroads self-dealing was a plain violation of Section 10, not even noticed in the Commission's Report. That case establishes for this Court that the debt was created in violation of this Section.

Moreover, the contracts relied upon to give REA's railroad owners a legal right to treat REA's sinking fund payments as their own, were a fraud upon REA's general creditors. As the owners controlling this corporation, the railroads could not equitably use that control to create a preference for themselves, as against other creditors. These railroads were guilty of a gross breach of trust when they, in practical effect, pocketed REA's sinking fund revenues; revenues that should have been used to increase REA's surplus by reducing the fixed debt incurred in acquiring REA's capital assets.

Before liquidation of REA became an imminent possibility, the railroads themselves regarded this debt as capital debt, subordinate to all other debts. But when liquidation or a sale of REA seemed desirable, the debt was converted into 14 year notes that fell due when REA was insolvent. The collection of interest on these notes during 1960-71 was fraudulent conduct that this Court should remedy, in addition to preventing enforcement of the notes.

2. The Commission erred in not disapproving the 1959 note issue under Section 20a. The *Minneapolis* case, cited above, did not as the Commission seems to assume, approve self-dealing in a carrier's securities. The Section 5(2) approval granted there was for a consolidation of competing carrier interests that might otherwise have violated Section 1 of the Sherman Act and Section 7 of the Clayton Act. 361 U.S. 173, 186.

The Section 5(1) approval granted in 1959 for a new contract was, according to the Commission, needed to per-

mit REA to become a "profit-making entity" capable of standing on its own feet. But the 1959 note issue approved under 20a served an opposite purpose. The note issue converted current open account debt into quasi-permanent debt that REA had no reasonable prospect of liquidating as an independent carrier. The 1959 sinking fund provision exposed the railroads' purpose to retain through ownership of the 27 million dollar debt, a dominant position as REA's principal creditors, regardless of who owned REA's stock.

Although the note issue matured in 1973 there was to be no amortization before 1965 and it would then be limited to 10 percent of REA's annual net profits. There was not in 1959 or at any later date, any reasonable prospect that any percentage of REA's net profits could retire this debt in the foreseeable future.

The railroads "hope," expressed in 1959, that REA would become profitable by 1965, was based on no experience whatsoever. No public purpose of any kind was served by assuring the railroads in 1959 that if REA was ultimately liquidated, no matter who owned it, the railroads note holders would still be its principal creditors. The close linkage of REA's management with its railroad owners during 1929-59, could not of course justify the extraordinary future burden that the 1959 note issue placed on REA.

Assuming the correctness of the Commission's 1929 conclusion that management identity between REA and the railroads in operating matters was desirable, this conclusion carried with it no sanction for the owners' dealings in REA's securities that injured REA. The 1929 Section 5 approval recognized that the railroads served by REA were not likely to compete with each other for REA's transportation business. When REA needed capital, however, REA's railroad owners never were or wanted to be the suppliers of the needed money. That came from bonds issued to the public, financed from express charges paid by

shippers. There were strong public policy reasons for applying Section 10 to REA's accumulation of debt to its owners. There were none whatsoever for immunizing from Section 10 liability this manipulation of REA's debt by the railroads for their exclusive benefit.

Section 20a was a product of disclosures made in railroad bankruptcies of destructive financial dealings. One of its aims was to prevent the precise kind of manipulation of common carrier finances that the railroads achieved in REA's case. The public interest it was designed to protect includes that of public creditors supplying equipment and services needed to conduct a carrier's business.

Although the Supreme Court recently construed 20a in considering the Greyhound Bus Company's attempted purchase of a stock interest in REA in 1964, this case is ignored in the Commission's 1975 Report. *Denver & R.G.W.R. Co.* v. *United States,* 387 U.S. 485 (1967). The Supreme Court, in reversing a 20a order of the Commission, approving the porposed Greyhound purchase, told the Commission that it must do two things that it did not do there or in the current REA case. First, the Commission must consider the purposes of the Clayton Act in a 20a proceeding. 387 U.S. 485, 496. Second, the Commission, in the 20a proceeding, cannot confine its consideration to the immediate transaction before it. The Commission must look ahead to the probable future consequences of its 20a approval before granting it. 387 U.S. 485, 505-506.

As applied to the current REA 20a proceeding, the Supreme Court's standards required the Commission to consider whether the underlying debt had been created in violation of Section 10 of the Clayton Act and to look ahead to the probable consequences of saddling REA with a twenty-seven million dollar unrepayable fixed debt to its railroad owners.

The reasons offered by the railroads for serving themselves were wrongly accepted by the Commission as REA's business reasons for issuing the 1959 notes. Even assuming that the underlying debt was legally created there was no public or REA interest in freezing it into a long-term, unrepayable obligation in 1959. The Commission should have disapproved the note issue and thus compelled the railroads to give some thought to the kind of financial structure that would allow REA to succeed.

Having obtained a Section 20a approval deliberately intended to injure other creditors, the railroads should not be allowed to retain the note interest collected by them, simply because the Commission mistakenly went along with their plan. The Commission's approval should be set aside with a declaration that the note issue was void, ab initio.

ARGUMENT

I. THE DEBT UNDERLYING THE 1959 NOTE ISSUE WAS CREATED IN VIOLATION OF SECTION 10 OF THE CLAYTON ACT.

In describing REA's retirement from its own revenues of the public debt that created its capital, as shareholders' advances, the 1975 Commission decision has tried to create a whole new world of corporation law. Owners of a corporation may advance their own money to the corporation and collect interest on such advances. But allowing shareholders to use a contractual interest in corporate assets to justify placing themselves in the shoes of the holders of public bonds retired by sinking fund payments, contradicts a fundamental rule of corporate life. A corporation is allowed to insulate its owners from liability for its debts but this immunity carries with it a prohibition against an owner's assertion of title to corporate assets, even if he owns all of its stock.

What the Commission has tried to sanction is a fraud on all those who advance credit to a corporate common carrier. When they do so they are entitled to look to all of the carrier's assets not pledged to other creditors for repayment. The railroads use of REA's sinking fund revenues to convert capital debt into interest bearing debt to themselves was a blatant fraud on other creditors of REA that no agency purporting to represent the public interest should tolerate.

REA Exhibit 46, a 1943 memorandum printed in full as Appendix B of this brief, describes in detail, the creation of "certificates of indebtedness" to the railroads by sinking fund payments on its public debt. However, it was not until the railroad owners began contemplating REA's liquidation, that they decided to place this debt on a par with that owed to other creditors. After 1954, instead of treating this debt as capital debt "subordinated to REA's other liabilities" (p. 187), they treated it as ordinary debt. In paying themselves interest on the capital debt, they were, in effect, paying themselves dividends from "funds properly includable in capital account," in violation of 49 U.S.C. 20a(2). When, in 1959, they decided to convert this debt into an extraordinary issue of 14 year notes, payable to themselves, REA's insolvency was assured.

Section 10 of the Clayton Act was itself a product of pre-1914 railroad bankruptcies but none of those bankruptcies was produced by a manipulation of carrier sinking funds so deliberately injurious to the carrier. The railroad owners' manipulation of REA's sinking funds to create unpayable debt to themselves appears to be unprecedented in railroad or Interstate Commerce Commission history.

The Commission's Bureau of Statistics published in 1939 a study called Railroad Sinking Funds and Funded Debt. The Summary states that the purpose of all sinking funds studied was to reduce the "debt-investment ratio," either by reducing the size of the debt or by increasing the size

of the investment. "A true sinking fund, however, reduces the ratio of debt to investment by reducing debt." p. X. Section 18, Conclusions, states as number 2 that "All sinking fund payments should be *directed strictly to the redemption of debt*" (p. 106, Emphasis ours).

This study was based on an examination of the sinking fund practices of fifty-one large Class I railroads, which showed their principal abuse of sinking funds to be the use of such funds to make other investments, instead of retiring the debt they were created to retire. But those investments were always the property of the carrier. In no case were a class I railroad's sinking fund payments allowed to replace public debt with equivalent debt to its owners. REA's general creditors were subjected by these railroads to a misappropriation of capital that none of them dared to inflict on its own creditors.

Since the Commission's 1975 report did not even notice REA's bankruptcy, it is not surprising that the Commission failed to comprehend Section 10 of the Clayton Act as an expression of public policy intended to prevent stockholders of a common carrier from defrauding other creditors.

> "A director is a fiduciary. *Twin-Lick Oil Co.* v. *Marbury,* 91 U.S. 587, 588. So is a dominant or controlling stockholder or group of stockholders. *Southern Pacific Co.* v. *Bogert*, 250 U.S. 483, 492. Their powers are powers in trust. See *Jackson* v. *Ludeling*, 21 Wall. 616, 624. Their dealings with the corporation are subjected to rigorous scrutiny and where any of their contracts or engagements with the corporation is challenged the burden is on the director or stockholder not only to prove the good faith of the transaction but also show its inherent fairness from the viewpoint of the corporation and those interested therein. *Geddes* v. *Anaconda Copper Mining Co.*, 254 U.S. 590, 599. The essence of the test is whether or not under all the cir-

cumstances the transaction carries the earmarks of an arms length bargain. If it does not, equity will set it aside. *While normally that fiduciary obligation is enforceable directly by the corporation, or through a stockholder's derivative action, it is, in the event of bankruptcy of the corporation, enforceable by the trustee. For that standard of fiduciary obligation is designed for the protection of the entire community of interests in the corporation—creditors as well as stockholders.*" *Pepper* v. *Litton,* 308 U.S. 295, 306-07 1939). Emphasis ours.

Section 10 has precisely the same purpose of preventing frauds on common carrier creditors that this equitable policy has with respect to frauds on all corporate creditors. Section 10's scope was exhaustively considered by the Second Circuit in *Klinger* v. *B. & O. Railroad Co.*, 432 F.2d 506 (1970). Although the Commission cites this case it does not say whether it thinks the Court was right or wrong in its construction of Section 10. We believe the Court correctly held that self-dealing in a carrier's securities, even where their issuance is incidental to the acquisition of a terminal, was within the scope of Section 10 and that Section 10 imposes liability on the persons whose violation of the section injures a carrier.

Here we have a bankruptcy producing common carrier debt manipulation that Section 10 was meant to prevent. REA's public debt was deliberately manipulated in a manner which avoided any possibility of using competitive bidding as a safeguard against injury to REA. The replacement of the public bonded debt with private bookkeeping debt to the controlling stockholders took place over thirty years, in private, semiannual transactions.

Section 10's purpose to prohibit flatly such injurious self-dealing whenever competitive bidding is absent, is plain. Nor does enforcement of Section 10's policy conflict with any regulatory function of the Commission. As we

shall show in the following section, the Commission's decision betrays both the public purposes of Section 5 immunity and the public interest standards of Section 20a.

II. THE COMMISSION SHOULD HAVE DISAPPROVED THE 1959 NOTE ISSUE PURSUANT TO SECTION 20a OF THE INTERSTATE COMMERCE ACT.

In 1959, the railroads were contemplating liquidation of REA and the Commission knew it. The decision approving the new contract said that one of its purposes was to avoid liquidation "if at all possible," 308 ICC 545, 546. There is not one word in that decision about the proposed 1959 note issue or the underlying debt. The Commission's decision says the "railroads hope that the REA may become a profit-making enterprise." (Id, p. 550); but this was not to be accomplished by burdening REA with new long-term debt. This was to be done by letting REA have net earnings, after June 30, 1961, which would be divided equally between REA and the railroads, and letting REA buy transportation from the railroads after June 1, 1963 on "a car-foot mile" basis. Id, p. 549. REA was also to be freed from restrictions that tended to tie its purchases of transportation service to its railroad owners. But how or when REA might be freed from the enormous debt to its railroad owners, built up during the preceding thirty years, was left for consideration in the separate 20a proceeding, in which the railroads sought Commission approval to convert that debt into 14 year notes.

The Commission is apparently now asserting that it did not have to consider any Section 10 issue in the 20a proceeding because it had exempted the railroads "from the operation of the Clayton Act by its approval of transactions under Section 5," citing *Minneapolis & St. Louis Railway* v. *United States*, 361 U.S. 173 (1959) (p. 210). This is a strange assertion since the brief of the United States and the Commission in that case asserted exactly the opposite. In commenting on the appellant's citation

of *In Re Missouri Pacific R. Co.*, 13 F.Supp. 888, E.D. Mo. (1935) the Commission's Brief says that the self-dealing there involved was "the typical kind of transaction at which the section (10 of the Clayton Act) was aimed and *one which, of course, was not subject to the approval of the Commission under Section 5 of the Interstate Commerce Act*" (Page 64, footnote 32). Emphasis and parentheses ours. It is also significant that the Commission did not dispute the Missouri District Court's conclusion that self-dealing is absolutely forbidden by Section 10 where, as here, "no competitive bids are possible." 13 F.Supp. 888, 893. In any event, there was no conflict between Section 10 objectives and Interstate Commerce Art objectives to provide a basis for considering Section 10 immunity.

In 1959, when REA's debt to the railroads had been built up by self-dealing to more than 27 million dollars, they thought it ought to be placed in a form that would resolve in their favor the nagging post 1954 controversy as to whether it was ordinary debt or capital debt. This was particularly desirable because they proposed to sell REA and when they did it would help them to have the debt in a form that would give them an apparently valid claim on most of REA's assets, in the event of bankruptcy. Bankruptcy was even then a likely fate because REA's ratio of surplus to fixed debt was dangerously low and it had no earnings. REA, was, in 1959 by any standard, an enterprise that should not have assumed the payment of huge interest charges on debt it could not liquidate from earnings.

According to the financial statement submitted with the application (C.I.[2] 1, Ex. 7, p. 16. App. ——) REA's fixed debt totalled nearly $52 million dollars while its excess of total assets over total liabilities was only $10 million.

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[2] C.I. refers to the Commission's Index of the Record.

This statement did not, however, include more than $3 million of liabilities in excess of reserve balances, shown in a supplemental statement filed with the Commission. Nor did it include any figure for unfunded pension liabilities that had reached nearly $15 million at the end of 1958 and were projected to reach $27 million by the end of 1973. REA Ex. 84 (C.I. 198, p. 320, App. ——). The railroads had agreed to be liable for these unfunded liabilities on REA's liquidation, under Article 17 of the 1954 operating agreement but this liability was omitted from the 1959 revision. REA's President made only an oblique reference to this omission when he told the Commission that this change in Article 17 was "clearly in line with the new independent status of the Express Company, which will now be expected to stand or fall on its own." R.R. Ex. 91, p. 10, App. ——).

Ultimate liquidation of REA was made inevitable by the 1959 notes because there was not then or subsequently any reasonable prospect that REA could earn enough money to pay-off the railroad note-holders. But these notes gave them assurance that, whoever owned REA, the railroads would have a first charge on REA's annual gross revenue of nearly one and one half million dollars in interest payments. During 1960-71 the total interest paid on these notes, more than fourteen million dollars, exceeded REA's total net income.[3]

The Commission's 1975 Report displays no discernible consideration of the adverse impact on REA of its 1959,

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[3] REA's net income and losses (in parentheses) to the nearest hundred thousand dollars, as shown on its annual reports to the Interstate Commerce Commission, during the period 1960-1971, were as follows:

1960—(100,000) App ——.	1966—(600,000) App ——.
1961— 3,000,000 App ——.	1967—(12,800,000) App ——.
1962— 6,300,000 App ——.	1968—(31,500,000) App ——.
1963— 2,400,000 App ——.	1969—(23,800,000) App ——.
1964— 1,000,000 App ——.	1970—(13,000,000) App ——.
1965— 1,000,000 App ——.	1971—(9,700,000) App ——.

20a approval of REA's note issue. What the Commission terms "sound business reasons" for creating this debt were railroad reasons.[4] The Commission's inability to distinguish the railroad interest from REA's interest or the public interest apparently stems from the identity of management then existing between them. But the railroads were, in 1959, considering destruction of that identity by a sale of REA.

Although the Commission's Report does not mention them, significant events immediately preceding the 1959 note issue are set forth in the record before it. On April 5, 1959, Mr. Charles Bowen, then Vice President of Booz, Allen & Hamilton, management consultants, had told REA's Board of Directors that huge "contingent termination expenses," which faced "not only the stockholders but also the participating railroads," meant that REA was "not in a proper position to die." REA Ex. 62, (C.I. 198, p. 217, App. ——). Die, that is, in the arms of the railroads. In his summary, he pointed out that these "Contingent contributions upon termination present a major threat to the railroads. Political retaliation is very likely if an *overt* effort is made to avoid them." Id., p. 222. Emphasis ours.

This led to consideration by the railroads of a sale of REA. REA Exs. 65 and 66 (C.I. 198, pp. 231-235, App. ——). On June 2, 1959, REA's Board voted to recommend

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[4] Liquidation advantages for the railroad stockholders were transmuted into REA "advantages" by some unexplained process. (pp. 172, 205). The stockholders said their concern for the non-stock owning Short Line Railroads, prompted the stockholders to refrain from using REA's sinking fund payments to increase its surplus by reducing its debt. The Commission swallowed this manipulation whole, as a high-minded gesture, meant to prevent the stockholders from enjoying increases in REA's surplus at the expense of the Short Lines (p. 205). Yet the Short Lines were had in the end because the Short Lines were totally excluded from the $28 million in 1929-59 interest, paid only to the stockholders. See Verified Statement of L. John Eichner, (C.I. 197, Attachment 1, p. 119, App ——).

acceptance of an offer made by Lehman Brothers, to its stockholders. REA Ex. 67 (C.I. 198, p. 237, App. ——). The Board also considered an offer made by Morris Forgash but disagreed as to its merits (Id., p. 238 App. ——). No sale occured.

The decision to reorganize REA under continued railroad ownership was then publicly announced by its President on July 2, 1959. REA Ex. 69 (C.I. 198, p. 243-45, App. ——). His announcement recited the operating changes made by the new contract, submitted to and approved by the Commission, without mentioning that it had eliminated the railroads' liquidation liabilities. Nor did he refer to the new note issue or the railroads' plan to unload REA.

The application for approval of the note issue was not made until September 1, 1959 (C.I. 1, App. ——). It asserted that the note issue "will not impair [REA's] ability to perform that [public] service and is reasonably necessary and appropriate for that purpose (Id., p. 5, App. ——). Parentheses ours. However, no facts are to be found in the application which could justify this conclusion. Moreover, the application does not, of course, disclose that a recommendation by REA's Vice President "that the notes be subordinated to all other indebtedness of the agency except perhaps, to the extent of the sinking fund.", REA Ex. 74, (C.I. 198, p. 242, App. ——), had been overridden.

The railroads' devotion to their own interests rather than REA's in issuing the notes is understandable. But the Commission's indifference to the adverse effect of the note issue on REA's future and upon other creditors is not. The effect of the note issue on REA's health as a common carrier, does not appear to have been considered by the Commission, even after bankruptcy had resulted. No one could guess from reading the Commission's final decision that REA had then become a bankrupt carrier.

When the Commission reopened its 1959 order for reconsideration it did so for the evident purpose of making an investigation in 1974 that it should have made, but didn't make, in 1959. The 1974 investigation produced statements ignored by the Commission, that the railroads' debt creating mechanism, was detrimental to proper operation of REA. It was described by a transportation consultant as the kind of self-dealing injurious to a carrier, thought to have been ended by Section 10 of the Clayton Act and 20a of the Commerce Act.

On October 9, 1974, L. John Eichner, a member of a professional consulting firm specializing in transportation matters, filed a verified statement (C.I. 197, pp. 81-146, App. ——) in which he estimated in dollar terms the financial injury inflicted on REA by its railroad owners during 1929-1969, (Id., pp. 103-104, App. ——). The interest paid by REA to the railroads on their "advances"[5] through 1961 totaled 30.3 million dollars. (Id., p. 104, App. ——). The interest paid on "advances" after July 1, 1961, when REA was supposed to become a profit-making entity, totaled 13 million dollars. (Id., p. 107, App. ——). He concluded that these payments, together with other injuries inflicted by REA's railroad owners "over the period 1929-68, made it impossible for the management of REA to conduct, properly, its business and to invest capital in the necessary facilities and equipment to maintain its service quality and its market share" (Id., p. 114, App. ——).

The Commission disregarded this statement but found no benefits to REA resulting from the "advances" Eichner discussed. If the Commission thought any public interest in efficient express service was served by the 1959 note issue its Report does not say what it was. Why the

[5] Eichner's reference to interest paid on "advances" includes both interest paid on the debt underlying the 1959 notes and interest paid subsequently on the notes themselves.

Commission did not apply in its decision the Section 20a standards spelled out by the Supreme Court in the Greyhound Purchase case, in 1967 (387 U.S. 485) is also not explained. If it thinks the law was different in 1959 we do not know what decision gave rise to that thought. In any event we believe the Supreme Court's Greyhound decision should control the decision of this Court.

In 1964 the Greyhound Bus Company proposed to solve REA's acute lack of working capital by acquiring a new issue of REA's stock for ten million dollars, in return for a 20 percent equity interest in the company. Its offer to purchase was also conditioned on an option to purchase enough of the railroad held shares of REA for $20 a share to give Greyhound control of more than 50 percent of the company.

The Commission approved this purchase under Section 20a over the objection of some dissenting railroad stockholders of REA, bus competitors of Greyhound and a number of trucking competitors of the railroads. Their complaint was that the Greyhound purchase would restrain express competition in violation of Section 7 of the Clayton Act. The Commission refused to hear the Section 7 objections, saying that it would deal with them in the Section 5(2) proceeding that would be required, when and if Greyhound acquired control of REA. A Colorado three-judge court affirmed. 255 F.Supp. 704.

The Supreme Court reversed, holding that the Commission must consider the alleged Clayton Act violation before it could approve the Greyhound application under Section 20a. 387 U.S. 485, 492-493. The fact that Greyhound was not threatening to acquire immediate control was immaterial. The Court said that the Commission must look ahead in the 20a proceeding to the possibility that Greyhound would acquire control at a future date. 387 U.S. 485, 504-506. Otherwise the Commission could not know "whether

the special action approved may operate to the detriment of REA or the public interest". Id at 506.[6]

It is clear from this decision that the Commission should have considered the Clayton Act violation alleged here before it re-affirmed its 1959 Section 20a order. The 1959 approval was pro forma because no one was objecting. Nevertheless, 20a requires the Commission to investigate the "uses and purpos " of a carrier's security issue, whether anyone obje or not. Had any investigation worthy of the name then been made it would have included a critical look at the self-dealing by which the underlying debt had been created. Amazingly, when the Commission's Administrative Law Judge and its own counsel both concluded in 1973 that this was not a valid debt the Commission rejected their conclusion. While this rejection was consistent with the Commission's rejection of views previously expressed to the Supreme Court by its counsel, the Commission's disregard for the resulting Supreme Court decision is inexplicable.

In reaffirming its 1959 mistake the Commission ignored the legislative history of 20a as well as the Supreme Court's Greyhound-REA decision, supra. Congress created 20a in 1920 because it then had before it the same history of railroad bankruptcies, caused by the improvident issuance of railroad securities, that produced Section 10 of the Clayton Act. The protected public includes both the issuer of common carrier securities and unrelated persons who may extend credit to a carrier. It does not include stockholders who cause the issuance of its securities to themselves. Their self-serving acquisitions of common carrier debt was precisely what Sections 10 and 20a were meant to prevent.

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6 The Commission's brief in that case disclaimed the power it asserts here "to relieve a transaction from the anti trust laws" in a 20a proceeding (pp. 24-25).

That Section 20a was intended to give the Commission power to implement the policy of Section 10 of the Clayton Act, is apparent from the legislative history of both statutes. 20a was Section 439 of the Transportation Act of 1920, (41 Stat. 494), a statute that also established in Section 501 a 1921 effective date for the Clayton Act's Section 10 (41 Stat. 499). A provision for Commission control over the issuance of all common carrier securities almost identical to the one that became 20a in 1920, had been passed by the House in the 1914 Congress that enacted Section 10. See footnote 4, 387 U.S. 485, 492 and MacVeagh, The Transportation Act of 1920, 486-489.

The 1914 origin of both Sections 10 and 20a was President Wilson's message of January 20, 1914, outlining his program for outlawing "private monopoly". Section 10 was originally Section 9 of H.R. 15657, which, according to the Report of the House Judiciary Committee, No. 627, dated May 7, 1914,[7] was meant to implement Wilson's promise to prohibit the corporate interlocks that make "those who borrow and those who lend practically one and the same." (p. 18).

Wilson's views had been influenced by Mr. Justice Brandeis and his classic work, *Other People Money*, published in 1914, probably had more influence in producing both Sections 10 of the Clayton Act and 20a of the Commerce Act than anything said by a member of the Congress. In Chapter III, Interlocking Directorates, under a sub-heading Nullifying the Law, he discusses Court decisions holding that self-dealing prohibitions make contracts merely voidable, instead of void and states his own belief that the only proper relief is to declare them absolutely void. (pp. 40-41), Harper Torchbooks Edition, 1967. In Chapter VII, A Curse of Bigness, under the sub-heading Recommendations, No. 3 was that no interstate railroad

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[7] All of the cited Clayton Act reports were made to the 63rd Congress, 2nd Session.

should be permitted to issue stock or bonds "without the approval of the federal government." Id., p. 127.

While this book was first published before the author was appointed to the Supreme Court, he had it reprinted in paperback, after sitting there for seventeen years. Id., Introduction by Richard M. Abrams, XXXIV. It is, we submit, a fair representation of what this Justice, who was perhaps the most astute analyst of corporate financial transactions ever to sit on the Court, thought about the problems dealt with in Sections 10 and 20a. While he does not appear to have had any occasion to deal with the problems presented here as a judge it seems safe to say that he would not have regarded 20a as providing an excuse for sanctioning harmful self-dealing in a carrier's securities that violated Section 10.

It is clear from the history of both statutes that Congress intended Section 20a to ensure Commission application to carrier security issues of the policy against self-dealing initiated in Section 10.

As it passed the House the Section that became 10, was broader than the final version and was limited by amendments in the Senate. According to its Report of July 22, 1914, No. 698, the prohibition against self-dealing was modified by the Senate to permit dealing with the lowest bidder in a competitive bidding situation, to take care of emergencies. "In the case of railroads, calamities of fire and flood might make it necessary in the shortest possible time and to a certain extent regardless of lesser consequences to replace engines, cars and bridges." (p. 48); a consideration that could never justify replacement of a carrier's public debt with private debt to its controlling stockholders, over a thirty year period. The final Conference Report, Senate Document No. 505, dated September 25, 1914 merely renumbered Section 9 as 10 (p. 8-9).

The Commission's 1975 indifference to the public interests committed by the Congress to its care, which were

then seriously threatened by REA's bankruptcy, is extremely odd. There is an obvious connection between REA's 1975 bankruptcy and a 1959 issue of 27 million dollars worth of 14 year notes, known to be unpayable when issued and actually defaulted in 1971, on which REA had to pay more than $14 million dollars in interest, and the sinking fund terms of these notes were a tip-off to the railroads' 1959 intentions. They provided for no amortization of a debt due in 1973 before 1965 and no amortization then except out of net profits from a carrier that had never had any. During 1965-1968, while still under railroad ownership, REA's operations yielded a net loss of about fifty million dollars.[8] The ten percent of net profits provided for amortization in the Commission approved agreement, could not have paid off these 14 year notes in fifty years of more profitable operations than REA's railroads owners could possibly have visualized for REA on the basis of their own 1929-1959 experience with it. What they could and did visualize was a prior claim on REA revenues in the form of substantial interest payments and permanent indirect control of REA, by perpetuating their status as REA's principal creditors.

We have found no case involving a fraud on creditors like the one perpetrated on REA's creditors by the notes issued to the railroad owners. However, long before these notes were issued it was clear that a corporation could not create a valid creditor position for persons who were in fact supplying venture capital to the corporation, by issuing certificates of indebtedness to them. This was established by the cases involving so-called "participating operation certificates", issued in the 1920's by gasoline distributors. The holders of those certificates had a contractual right to a specified part of filling station revenues, formally designated as a trust fund created for their benefit. Deposits in various banks were made for the payment

[8] See footnote 3, (p. 18) supra.

of these obligations under designations such as "sinking fund" or "bond fund." However, two District judges held that on liquidation, general creditors were entitled to such deposits, as against the certificate holders.

Judge Schoonmaker thought that "To give validity to such a contract would be to establish a legal vehicle for corporation fraud and illegal preference of creditors." *United States* v. *Keystone Auto Gas & Oil Service Co*, 19 F.2d 624, 626, D.C.W.D.Pa. (1924). Judge Morris held that such certificates, even when supported by mortgages, must give way before general creditors because the holders were "co-adventurers with the stockholders, hazarding their investment upon the continued operation, and hence upon the success of the company." In re *Hawkeye Oil Co.*, 19 F.2d. 151, 152, D.Ct. Delaware (1927). Since there was no self-dealing in the issuance of these certificates and fresh capital for the corporation's use was actually contributed by the certificate holders, the fraud on general creditors committed in those cases was insignificant when compared to the railroads' fraud on REA's general creditors.

CONCLUSION

The Commission can not reimburse REA's non-railroad creditors for the railroads' fraud upon them and seems determined to deny them relief against the railroad noteholders. Any equitable recovery must therefore be founded on a decision by this Court setting aside the Commission's order.

The railroads were only able to extract interest on the 1959 notes from REA by an erroneous Commission approval they sought and got with knowledge of its inevitable injury to REA and its other creditors. We submit that, as a matter of simple justice to REA's creditors, the 1959 notes should be declared void from their inception and invalidation of the notes should at least carry with it, an

obligation to repay to REA's Trustee in Bankruptcy the interest illegally collected. Since it does not now appear likely that even such repayment, with interest, will be adequate to satisfy the claims of non-noteholding creditors, we have omitted any discussion of the alleged "windfall" to REA's present stockholders that might result from invalidation of the notes. As matters now stand, validation of the notes would mean a windfall to the railroad noteholders at the expense of legitimate creditors. Nevertheless, we respectfully submit, that in reviewing the Commission's action, consideration of the public policy embodied in the applicable statutes, rather than speculation about who may get a windfall, should control this Court's decision.

Respectfully submitted,

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APPENDIX

APPENDIX A

Section 10 of the Clayton Act

15 U.S.C. § 20. Purchases by common carriers in case of interlocking directorates, etc.

No common carrier engaged in commerce shall have any dealings in securities, supplies, or other articles of commerce, or shall make or have any contracts for construction or maintenance of any kind, to the amount of more than $50,000, in the aggregate, in any one year, with another corporation, firm, partnership, or association when the said common carrier shall have upon its board of directors or as its president, manager, or as its purchasing or selling officer, or agent in the particular transaction, any person who is at the same time a director, manager, or purchasing or selling officer of, or who has any substantial interest in, such other corporation, firm, partnership, or association, unless and except such purchases shall be made from, or such dealings shall be with, the bidder whose bid is the most favorable to such common carrier, to be ascertained by competitive bidding under regulations to be prescribed by rule or otherwise by the Interstate Commerce Commission. No bid shall be received unless the name and address of the bidder or the names and addresses of the officers, directors, and general managers thereof, if the bidder be a corporation, or of the members, if its be a partnership or firm, be given with the bid.

Any person who shall, directly or indirectly, do or attempt to do anything to prevent anyone from bidding, or shall do any act to prevent free and fair competition among the bidders or those desiring to bid, shall be punished as prescribed in this section in the case of an officer or director.

Every such common carrier having any such transactions or making any such purchases shall, within thirty days after making the same, file with the Interstate Commerce

Commission a full and detailed statement of the transaction showing the manner of the competitive bidding, who were the bidders, and the names and addresses of the directors and officers of the corporations and the members of the firm or partnership bidding; and whenever the said commission shall, after investigation or hearing, have reason to believe that the law has been violated in and about the said purchases or transactions, it shall transmit all papers and documents and its own views or findings regarding the transaction to the Attorney General.

If any common carrier shall violate this section, it shall be fined not exceeding \$25,000; and every such director, agent, manager, or officer thereof who shall have knowingly voted for or directed the act constituting such violation, or who shall have aided or abetted in such violation, shall be deemed guilty of a misdemeanor and shall be fined not exceeding \$5,000 or confined in jail not exceeding one year, or both, in the discretion of the court.

Oct. 15, 1914, c. 323, § 10, 38 Stat. 734.

Section 20a(2) of the Interstate Commerce Act

Issuance of securities; assumption of obligations; authorization

49 U.S.C. § 20a(2) It shall be unlawful for any carrier to issue any share of capital stock or any bond or other evidence of interest in or indebtedness of the carrier (hereinafter in this section collectively termed "securities") or to assume any obligation or liability as lessor, lessee, guarantor, indorser, surety, or otherwise, in respect of the securities of any other person, natural or artificial, even though permitted by the authority creating the carrier corporation, unless and until, and then only to the extent that, upon application by the carrier, and after investigation by the commission of the purposes and uses of the proposed issue and the proceeds thereof, or of the proposed assumption of obligation or liability in respect of the se-

curities of any other person, natural or artificial, the commission by order authorizes such issue or assumption. The commission shall make such order only if it finds that such issue or assumption: (a) is for some lawful object within its corporate purposes, and compatible with the public interest, which is necessary or appropriate for or consistent with the proper performance by the carrier of service to the public as a common carrier, and which will not impair its ability to perform that service, and (b) is reasonably necessary and appropriate for such purpose.

February 28, 1920, c91, Sec. 439, 41 Stat. 494

An amendment of July 24, 1965, Pub.L. 89-86, Sec. 1, 79 Stat. 263, added a provision exempting securities issued by governmental agencies, not material here.

APPENDIX B

Finance Docket
No. 20812
REA Exhibit 46,
C.I. 198, pp. 143-44

New York, November 12, 1943

On November 11 Messrs. Benson, Jump, Wilson and H.S.M., discussed the subject of issuing notes to cover advances, and on November 12th Messrs. Benson, Wilson and H.S.M. discussed the subject further.

There are many complications involved in issuing notes, including the question as to whether they should be negotiable or non-negotiable. There would be difficulty in registering or keeping a record as to the holders of the notes, several hundred of which would be issued over the period involved, and if any of them get into the hands of third persons it might interfere with any plan of refinancing or liquidation of the notes or exchanging them for preferred or other stock which the railroad stockholders might desire to arrange at some future time.

The Accounting Department has issued monthly, since 1931, and probably since 1929, memorandum to each railroad, a statement of express privileges and deductions therefrom, and it seems entirely proper and equitable to regard these statements as evidence of the indebtedness and as certificates of indebtedness within the intent of Congress which apparently was to give credit for bonafide indebtedness of which some written evidence exists. Thus there are written evidences of the indebtedness represented by the advances to the full amount thereof. It seems that the better course to follow is to take that position with respect to excess profits taxes and insist that the full amount of the advances is properly deductible.

The evidence consists of certificates of indebtedness in that they are statements by the Agency of the truth or

fact that it is indebted to the several railroads in the amounts shown. Anyone of these railroads could, no doubt, bring suit against the Agency and obtain a judgment on the basis of that statement.

The courts hold that they are not interested in the name used in connection with the document but are interested in its essential characteristics and the actual transaction involved. This construction may be placed upon the use by Congress of the term "certificates of indebtedness" and the intent of Congress in the language used in the Federal Income Tax Act, I.C.C. Act, and provisions respecting stamp taxes, the provisions with respect to which should be handled on their own basis, no one being controlling with respect to the other, just as the fact that Congress requires the Agency to apply rates for depreciation as fixed by the I.C.C. for certain purposes but permits the Bureau of Internal Revenue to use other rates for income tax purposes.

If notes or other evidences of the indebtedness are issued now, it might well be construed as an admission that the indebtedness has not been properly evidenced in the past. Any advantage which might be gained by issuing notes or evidences of indebtedness at this time is offset by this fact, coupled with the disadvantages which there would be in connection with such issuance.

If the question is raised as to necessity of I.C.C. approval for the issuance of such evidence, the position may be taken that such approval was given when the I.C.C. approved the issuance of bonds and later of notes and the plan for payment by means of advances.

If the question is raised as to whether such evidences are subject to stamp tax, the argument may be made that they are not because they fall under the principle followed by Congress in not making notes subject to stamp taxes, that is to say, they are not securities issued which are to

get into the hands of the public but are transactions between the Agency and the individual railroads, more in the nature of notes. If the question becomes important stamp taxes may be paid at any time in the future, if such action seem advisable.

If the position can be sustained that the Agency can have no taxable net income, then it will not be necessary to meet the issue with respect to the matter of evidencing the advances by notes or otherwise.

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

C. ORVIS SOWERWINE, Trustee in Bankruptcy of REA EXPRESS, INC., a Bankrupt, Plaintiff,	:	
v.	:	Civil Action No. 71-4278 (W.K.; Three-Judge Court)
THE ALABAMA GREAT SOUTHERN RAILROAD COMPANY, et al., Defendants.	:	

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

C. ORVIS SOWERWINE, Trustee in Bankruptcy of REA EXPRESS, INC., a Bankrupt, Petitioner,	:	
v.	:	Nos. 75-4209 & 76-4103
UNITED STATES OF AMERICA and INTERSTATE COMMERCE COMMISSION Respondents.	:	

CERTIFICATE OF SERVICE

I hereby certify that the Brief on behalf of the Plaintiff-Petitioner has been served this day upon the following counsel, by hand delivery to those listed in Washington, D.C., and by depositing same in the United States mail, postage prepaid, to those listed in other cities.

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